



Billing Code: 8025-01

SMALL BUSINESS ADMINISTRATION

13 CFR Part 107

RIN: 3245-AG68

Small Business Investment Companies (SBIC); Early Stage Initiative

AGENCY: U.S. Small Business Administration.

ACTION: Notice of proposed rulemaking.

SUMMARY: In this proposed rule, SBA is making changes to its Early Stage Small Business Investment Company (SBIC) initiative, which was launched in 2012 as a 5-year effort as part of President Obama's Startup America Initiative. The intent of the initiative was to license and provide SBA-guaranteed leverage to Early Stage SBICs that would focus on making investments in early stage small businesses. Although 62 investment funds applied to the program, few satisfied SBA's licensing criteria. To date, SBA has only licensed five Early Stage SBICs. In an attempt to attract more qualified early stage fund managers, this rule proposes changes to the initiative with respect to licensing, non-SBA borrowing, and leverage eligibility. These proposed changes are based in part on feedback SBA received on an Advance Notice of Proposed Rulemaking (ANPRM) that was published in March 2015. In addition, this rule reflects SBA's intention to continue licensing and providing SBA-guaranteed leverage to Early Stage SBICs beyond the 5-year term of the initiative, and proposes certain technical changes to SBA's Early Stage regulations.

DATES: Comments on the proposed rule must be received on or before [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit comments, identified by RIN 3245-AG68, by any of the following methods:

Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.

Mail, Hand Delivery/Courier: Mark Walsh, Associate Administrator for the Office of Investment and Innovation, U.S. Small Business Administration, 409 Third Street, SW., Washington, DC 20416.

SBA will post comments on <http://www.regulations.gov>. If you wish to submit confidential business information (CBI) as defined in the User Notice at <http://www.regulations.gov>, please submit the information to Theresa Jamerson, Office of Investment and Innovation, 409 Third Street, SW, Washington, DC 20416. Highlight the information that you consider to be CBI and explain why you believe this information should be held confidential. SBA will review the information and make the final determination of whether or not it will publish the information.

FOR FURTHER INFORMATION CONTACT: Theresa Jamerson, Office of Investment and Innovation, (202) 205-7563.

SUPPLEMENTARY INFORMATION:

I. Public Participation

SBA invites comments, data, and information from all interested parties, including but not limited to investors, small businesses, advocacy groups, nongovernmental organizations, and legal representatives with relevant expertise on any and all aspects of this proposed rule. Comments that will provide the most assistance to SBA in developing these procedures will reference a specific portion of the proposed rule, explain the reason

for any recommended change, and include data, information, or authorities that support such recommended change. SBA is generally seeking comments on:

- A. Proposed licensing requirements for Early Stage SBICs;
- B. Proposed evaluation of Early Stage SBICs by SBA;
- C. Proposed treatment of third-party debt of Early Stage SBICs;
- D. Proposed maximum amount of leverage for Early Stage SBICs, both individually and annually in aggregate;
- E. Constraints of equity versus debenture financing as articulated in the proposed rule;
- F. Treatment of interest reserve, capital impairment, and cost of money in the proposed rule;
- G. Alternative financing terms compared with those in the proposed rule, such as discounted debentures and longer-maturity debentures;
- H. Access by non-leveraged SBICs to Early Stage SBIC leverage under the proposed rule;
- I. Alignment of the proposed rule with early stage investment strategies, including the relatively long time horizons of early-stage investors in capital-intensive technologies; and
- J. Other suggested changes that SBA has not included in this proposal.

SBA also invites comments on the economic and financial analyses supporting this rule.

II. Background Information

In the Small Business Investment Act of 1958 (Act), Congress created the Small Business Investment Company (SBIC) program to “stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply” 15 U.S.C. 661. Congress intended that the program “be carried out in such manner as to insure the maximum participation of private financing sources.” Id. In accordance with that policy, the U.S. Small Business Administration (SBA) does not invest directly in small businesses. Rather, through the SBIC program, SBA licenses and provides debenture leverage to SBICs. SBICs are privately-owned and professionally managed for-profit investment funds that make loans to, and investments in, qualified small businesses using a combination of privately raised capital and debenture leverage guaranteed by SBA. SBA will guarantee the repayment of debentures issued by an SBIC (Debentures) based on the amount of qualifying private capital raised by an SBIC up to a maximum amount of \$150 million.

The standard Debenture requires semi-annual interest payments. Consequently, most SBICs finance later stage small businesses with positive operating cash flow, and most structure their investments as loans or mezzanine debt in an amount that is at least sufficient to cover the SBIC’s Debenture interest payments. Early stage companies typically do not have positive operating cash flow and therefore cannot make current interest or dividend payments. As a result, investments in early stage companies do not fit naturally with the structure of debenture leverage.

Early stage businesses without the necessary assets or cash flow for traditional bank funding face difficult challenges accessing capital. As a result of this capital gap, and as part of President Obama's Startup America Initiative, on April 27, 2012, SBA published a final rule (77 FR 25042) to define a new sub-category of SBICs. SBA's intent was to license over a 5-year period (fiscal years 2012 through 2016) venture funds focused on early stage businesses. Because Early Stage SBICs present a higher credit risk than traditional SBICs, that rule authorized SBA to guarantee Debentures only in an amount equal to each Early Stage SBIC's Regulatory Capital (consisting of paid-in capital contributions from private investors plus binding capital commitments from Institutional Investors, as defined in existing §107.50), up to a maximum guarantee amount of \$50 million. SBA allocated \$200 million per year (\$1 billion total) of its SBIC Debenture authorization over these years to this effort.

Since 2012, SBA has received 62 applications to the Early Stage SBIC program, but licensed only five Early Stage SBICs. Those applicants that were not licensed failed to meet SBA's licensing criteria. Many of these applicants had management teams with limited track records and few positive realizations. In order to determine the market need for SBA to continue licensing Early Stage SBICs past fiscal year 2016, SBA sought input from the public through an Advance Notice of Proposed Rule Making (ANPRM) on March 18, 2015 (80 FR 14034). In the ANPRM, SBA also sought input regarding what changes should be made to the program to attract qualified early stage fund managers.

Comments on the ANPRM and additional discussions SBA held with industry participants indicated that the program should be continued because funding gaps, especially in certain geographic areas and industries, continue to pose challenges for

early stage businesses. Based on SBA's analysis of the financing data available on the PricewaterhouseCoopers' Moneytree website (www.pwcmoneytree.com), although the venture capital industry provided over \$81 billion in financings to U.S. businesses between January 2014 and June 2015, less than a third went to early stage or start-up businesses. Additionally, venture capital financings were geographically focused, with over three quarters of venture capital dollars going to three states: California, New York, and Massachusetts.

In comparison, based on financing data Early Stage SBICs reported in SBA Form 1031 (Portfolio Financing Report), Early Stage SBICs reported that over 69% of their financing dollars through September 2015 were invested in states other than California, New York, or Massachusetts. Also, Early Stage SBICs reported that investments they have made in early stage small businesses have resulted in net job growth. SBA compared job data submitted by the existing Early Stage SBICs on SBA Form 1031 at the time of first financing to that submitted on SBA Form 468 (Annual Financial Report) for the reporting period as of December 31, 2014. This data indicated that Early Stage SBIC portfolio companies increased job growth on a net basis by 48% from the date of initial Early Stage SBIC investment through the reporting period.

SBA received suggestions for program improvement both through the ANPRM and discussions with industry. This proposed rule incorporates some of those suggested changes.

III. Section by Section Analysis

Section 107.310 – When and how to apply for licensing as an Early Stage SBIC

The proposed rule would remove §107.310 in its entirety. The current regulation sets forth two restrictions specific to the licensing of Early Stage SBICs. First, Early Stage SBIC applications may be submitted only during a limited timeframe identified in a Notice published in the Federal Register (which SBA has published on an annual basis since 2012). This restriction was put in place to enable SBA to manage the flow of applicants and properly allocate the \$200 million annual Early Stage leverage among all successful applicants. Since the demand for Early Stage licenses from qualified fund managers has been well below capacity, the proposed rule would allow Early Stage applicants to apply at any time, similar to other SBIC applicants. SBA believes that if the demand for Early Stage licenses increases to such an extent that SBA becomes concerned about leverage availability, SBA will be able to manage the flow of applicants and leverage issued through §107.320, an existing regulation that gives SBA the right to maintain diversification of Early Stage SBICs with respect to the year in which Early Stage SBICs commence operations.

The second restriction set forth in current §107.310 states that SBA will not consider an application from an applicant under Common Control with an existing Early Stage SBIC that has outstanding Debentures or Debenture commitments. This requirement was put in place to promote fund manager diversification and because the short term duration of the original initiative would not have given existing Early Stage SBICs time to realize investments sufficiently to qualify for a subsequent fund. Since the proposed rule would make the initiative an ongoing part of the SBIC program, SBA is proposing to remove this restriction. SBA would review requests for subsequent Early Stage licenses similar to other SBIC subsequent license requests, by considering such factors as the existing

SBIC's investment cycle, operating and regulatory history of the existing SBIC, anticipated co-investment between the proposed and existing SBIC, realizations since the existing SBIC was licensed, forecasted realizations and repayment of leverage, and consistency of management teams and limited partners between the existing SBIC and applicant.

One of SBA's strategic goals, as set forth in the FY2014 – 2018 Strategic Plan, is to ensure inclusive entrepreneurship by expanding access and opportunity to small businesses and entrepreneurs, including women, minorities, veterans and other entrepreneurs, in communities where market gaps remain. SBA encourages fund managers with early stage investment strategies that focus on these diverse communities to apply for licensing as an Early Stage SBIC.

Section 107.320 – Evaluation of Early Stage SBICs.

Current §107.320 gives SBA the right to maintain diversification among Early Stage SBICs with respect to: (a) the year in which they commence operations, and (b) their geographic location. The proposed rule would clarify that diversification by geographic location would be with regard to where the fund would be investing rather than where the fund is located. Although SBA believes that Early Stage investors typically invest close to where they are located since they are often actively involved with their portfolio companies, this proposed change would clarify SBA's original intent.

Section 107.565 - Restrictions on third-party debt of Early Stage SBICs.

Although current regulations allow standard SBICs to incur unsecured third party debt without SBA approval, current §107.565 requires Early Stage SBICs to obtain prior SBA approval in order to have, incur or refinance any third party debt, whether secured

or unsecured. This restriction was created because of the high risk profile of Early Stage SBICs. Even debt that is unsecured increases SBA's credit risk because SBA leverage is never senior to the claims of other unsecured creditors: under §107.560, the first \$10 million of SBA leverage is generally subordinated to other unsecured debt of an SBIC, and leverage above \$10 million is pari passu with other unsecured debt. Nonetheless, SBA recognizes that it is typical practice for investment funds, including those pursuing venture capital strategies, to use a line of credit to help bridge capital needs for financings – investment funds use lines of credit to fund financings and operations between capital calls, and can generally draw on a line of credit more quickly than investors pay in capital when called. To provide Early Stage SBICs access to this industry-standard tool while minimizing the credit risk to SBA, this proposed rule would allow current and future Early Stage SBICs to obtain an unsecured line of credit without SBA approval under the following conditions:

(1) ***The line of credit is limited to the lesser of 20% of Regulatory Capital or total unfunded binding commitments from Institutional Investors minus any such commitments included in the Interest Reserve under §107.1181.*** Since the line of credit will be used to bridge private capital calls to enable an Early Stage SBIC to finance a small business, SBA believes that the line of credit should not exceed the maximum amount that may be invested into a single portfolio company. Existing §107.740 calculates the maximum amount an SBIC may invest in a single portfolio company based on certain changes to an SBIC's Regulatory Capital, but this amount is generally 20% of Regulatory Capital. For simplicity, the proposed rule would set the borrowing limit to be no greater than 20% of Regulatory Capital as determined by the Capital Certificates

submitted from time to time by the SBIC. Additionally, the line of credit should be no greater than the amount of capital available for call from investors. Early Stage SBICs use unfunded binding commitments from investors for three primary purposes: (1) to call capital to finance small businesses, (2) to call capital to fund operations, and (3) to fund the Interest Reserve required under §107.1181. Since Early Stage SBICs cannot call unfunded commitments associated with the Interest Reserve (unless they are using that capital to pay interest on SBA-guaranteed leverage or SBA annual charges), the line of credit should be no greater than unfunded binding commitments from Institutional Investors minus any commitments associated with the Interest Reserve.

(2) ***The term of the line of credit does not exceed 24 months.*** Based on feedback from industry, SBA understands that most lines of credit are renewed on an annual basis. In this rule, SBA is proposing a 24 month limitation on the duration of the line of credit, which SBA believes should be sufficiently long so as to not impact the standard maturity dates in typical line of credit documentation. An Early Stage SBIC may renew the line of credit during its lifecycle as long as each renewal is no longer than 24 months and the Early Stage SBIC is in compliance with the requirements of this section.

(3) ***The line of credit is held by a federally regulated financial institution.*** SBA proposes this requirement, that the lender be regulated by a federal financial institutions regulator (e.g., the FDIC, OCC, or NCUA) to ensure that the lender is creditworthy, that the credit terms are reasonable and customary, and that the lender will not seek unusual remedies in the event of a default.

(4) ***All borrowings under the line of credit: (i) Are not secured third-party debt, as that term is defined under §107.550(a); (ii) Are for the purpose of maintaining the***

Early Stage SBIC's operating liquidity or providing funds for a particular Financing of a Small Business; (iii) Must be fully repaid within 90 days after the date they are drawn; and (iv) Must be fully paid off for at least 30 consecutive days during the Early Stage SBIC's fiscal year. SBA proposes these requirements to ensure that such debt is unsecured, since secured third party debt presents a higher credit risk to SBA and must be approved by SBA under §107.550. Further, the third party debt must be solely for the purpose of maintaining the SBIC's operating liquidity or providing funds for a particular financing of a small business. Finally, since such borrowings are temporary in nature, the line of credit should be repaid quickly and not continuously refinanced. SBA believes these requirements are typical for a line of credit and would provide Early Stage SBICs with access to a standard industry tool while minimizing SBA's credit risk.

Section 107.1150 Maximum amount of Leverage for a Section 301(c) Licensee

Current §107.1150(c) limits Early Stage SBICs to SBA-guaranteed leverage and leverage commitments of 100 percent of Regulatory Capital or \$50 million, whichever is less. Originally, the \$50 million maximum was set in order to provide increased diversity to the Early Stage SBIC portfolio. Comments to the Early Stage ANPRM indicated that a higher maximum would be more attractive to experienced early stage fund managers and suggested either \$75 million or \$100 million as a maximum leverage ceiling. Given that SBA's goal is still to keep the overall amount of Early Stage leverage to \$200 million in any given year, SBA believes that \$75 million is responsive to the feedback SBA has received and is a more appropriate amount than \$100 million to help achieve diversification within the Early Stage program. This proposed maximum would be available to future Early Stage SBICs as well as existing Early Stage SBICs.

The proposed rule would change the references to \$50 million in both §107.1150(c)(1) and §107.1150(c)(3)(iii) to \$75 million to reflect the increase in SBA-guaranteed leverage.

It should be noted that SBA's approval of leverage commitments to, and draws by, Early Stage SBIC applicants would remain subject to SBA credit policies and SBA's overall SBIC Debenture leverage authorization. Also, as discussed above, under existing §107.320, SBA will also continue to maintain the right to require diversification among Early Stage SBICs by year and geography as part of the evaluation of Early Stage SBICs in the licensing process.

Compliance with Executive Orders 12866, 12988, 13132, 13563, the Paperwork Reduction Act (44 U.S.C. Ch. 35) and the Regulatory Flexibility Act (5 U.S.C. 601-612)

Executive Order 12866

The Office of Management and Budget has determined that this rule is a "significant" regulatory action under Executive Order 12866. The Regulatory Impact Analysis is set forth below.

1. Necessity of Regulation

As discussed above, early stage financing gaps remain, and SBA's Early Stage SBICs are financing these gaps and creating jobs. This proposed rule reflects SBA's intention to continue licensing and providing SBA-guaranteed leverage to Early Stage SBICs, and implements changes to improve the program and attract more qualified fund managers to continue to finance those gaps. Based on industry feedback, SBA believes that minor changes could improve the program without increasing credit risk to SBA.

For example, removing the call process and accepting Early Stage SBIC applications on a rolling basis would allow fund managers to organize funds on their own timeline and allow fund managers to apply in a manner more conducive to their fundraising process. In addition, increasing the maximum leverage to \$75 million would be more attractive to qualified managers that are able to raise higher amounts of capital and are seeking more capital to round out their fundraising. At the same time, maintaining a maximum one to one ratio of leverage to private capital would permit this increase to maximum leverage without increasing the risk to SBA. Moreover, allowing fund managers of existing Early Stage SBICs to apply for a subsequent license would help successful fund managers continue to fund early stage small businesses. Finally, allowing Early Stage SBICs to access a line of credit, similar to other venture funds and standard SBICs, would streamline Early Stage SBIC cash management and operations.

2. Alternative Approaches to Regulation

SBA considered making no changes to the Early Stage regulations and not issuing any further calls for Early Stage SBICs. However, based on industry feedback received through the ANPRM process, which is supported by industry statistics, gaps in the market place still remain for early stage financings. Because Early Stage SBICs are financing that gap and creating jobs, SBA decided to make the Early Stage program an ongoing part of the SBIC program and propose as part of this rule those changes suggested by industry that would not increase risk but would help to improve the program.

As part of the ANPRM process and discussions with industry, SBA received several suggested changes that the Agency either could not implement or chose not to implement primarily due to cost and risk. These include the following:

- *Implementing a true equity program.* Although SBA agrees that an early stage investment strategy would be more ideally funded with equity capital than the currently structured Debenture, SBA is not authorized by the Act to take equity positions in SBICs or make direct equity investments in small businesses. SBA has tried to provide for a leverage structure that balances risk/cost and usability by venture investors.
- *Lowering or removing the Interest Reserve.* Early Stage SBICs currently have access to a Debenture that requires quarterly interest payments throughout its term. Current §107.1181 requires that for each Debenture that requires periodic interest payments to SBA during the first five years of its term, an Early Stage SBIC must maintain a reserve (consisting of either unfunded commitments from Institutional Investors or restricted cash in a segregated account) sufficient to pay the interest and annual charge on such Debenture for the first 21 payment dates following the date of issuance. SBA modeled both lowering the number of years required for the Interest Reserve and removing the Interest Reserve completely to identify the impact to the annual charge. The annual charge is an amount that SBA formulates each year and is paid by SBICs with outstanding leverage to offset projected SBIC Debenture losses and keep the Debenture program at zero subsidy cost. The Interest Reserve decreases SBA's credit risk for Early Stage SBICs; therefore, making the proposed changes to the Interest Reserve would have required all SBICs to pay a higher annual charge. SBA received input on these impacts from three of its five Early Stage SBICs, all of which preferred a

lower annual charge rather than changes to the Interest Reserve. SBA therefore decided not to pursue this option.

- *Implementing an accruing Debenture with longer maturity.* In addition to the Debenture discussed above, Early Stage SBICs have access to a Debenture that is issued at a discount and does not require interest payments during the first five years of its term. In response to industry suggestions to modify the Debenture to align better with early stage cash flows, SBA considered creating a Debenture that would not be issued at a discount and would not require interest payments over a 10 or even 15 year period, but would accrue interest that would be payable at maturity. Evaluation of this instrument must take into account the fact that SBA's guarantee includes both the leverage principal and accrued interest. Using such a non-discounted accruing Debenture, if an Early Stage SBIC with \$75 million in Regulatory Capital were to issue \$75 million in Debentures, the \$75 million in Debenture proceeds plus the accrued interest would exceed both the 1 tier of leverage maximum and \$75 million maximum leverage guarantee amount for the Early Stage SBIC. If an SBIC issued Debentures at the full face amount of \$75 million with interest accruing at a 5% rate and an annual charge of 1%, this would accrue in 5 years to over \$100 million, in 10 years to over \$134 million, and in 15 years to over \$179 million. At the 15 year point, the maximum leverage guarantee would exceed the maximum leverage allowed by statute. In this scenario, the Debentures must be issued at a discount, and extending the 5-year discount to a 10 or 15 year timeframe would decrease the amount of proceeds the Early Stage SBIC would receive at time of issuance. For example, a Debenture

that would accrue in five years to \$1 million may provide an Early Stage SBIC with only \$750,000 in proceeds, based on a 4% interest rate and a 1% annual charge. Increasing the accrual period to 10 years would reduce those proceeds to less than \$600,000. At a higher interest rate, these Debenture proceeds would be reduced even further. SBA believes this would make the instrument less attractive.

- *Providing more flexibility with regard to capital impairment.* One of the ANPRM comments indicated that Early Stage SBICs should be provided with more flexibility in regard to capital impairment, the primary financial metric SBA uses to evaluate SBIC financial performance. Most Early Stage SBICs have a 70% maximum allowable capital impairment percentage (CIP). CIP measures the amount of operating and investment losses against an SBIC's Regulatory Capital. If an Early Stage SBIC exceeds its maximum CIP, after notifying the SBIC and giving the SBIC a cure period of at least 15 days, SBA may invoke the remedies identified in §107.1810(g), which include, among other things, declaring the Debentures and any accrued interest immediately due and payable. SBA has decided not to modify the maximum allowable CIP for Early Stage SBICs because SBA generally experiences leverage losses with SBICs whose CIPs are in excess of 70%.

Furthermore, the existing Early Stage regulations already include adequate flexibility for Early Stage SBICs with respect to CIP. SBA previously operated a program that focused on equity investment called the Participating Securities program. That program generally allowed SBICs to have up to 85% maximum

CIP in the first five years following the first issuance of leverage. In originally developing the Early Stage rule, SBA noted that SBA incurred leverage losses for most Participating Securities SBICs when the SBIC's CIP went over 85%. For the few Participating Securities SBICs that did fully repay SBA leverage, higher CIPs were often the result of the loss of "Class 2 Appreciation" on the SBIC's investments. Class 2 Appreciation, defined in §107.1840(d)(3), relates to unrealized appreciation on securities that are non-public securities of a small business based on a new round of outside financing within the last 24 months. After 24 months, an SBIC's Class 2 Appreciation could "time out" and the SBIC would no longer receive credit for it in the CIP calculation. Current §107.1845 allows Early Stage SBICs to request approval to extend the validity of Class 2 Appreciation beyond 24 months based on relevant information, including a third party valuation. SBA believes this provision provides sufficient flexibility for Early Stage SBICs with respect to CIP while properly limiting SBA's credit risk.

- *Change cost of money rules for Early Stage SBICs.* Current §107.855 generally limits the interest an SBIC may charge a small business on Debt Securities to 14 percent and Loans to 19 percent. SBA received comments that Early Stage SBICs should be allowed greater flexibility with cost of money provisions. SBA does not believe that such changes would significantly help Early Stage SBICs, which are primarily making equity investments that are not subject to the cost of money limitations.
- *Non-leveraged SBIC access to Early Stage leverage.* SBA received comments in response to the ANPRM stating that SBA should allow non-leveraged SBICs that

have an early stage strategy to access Early Stage leverage. In the licensing process for non-leveraged applicants, SBA does not perform the same level of financial review that it does for applicants that intend to use leverage. A request of this type would require SBA to undertake a substantive review of the non-leveraged SBIC's qualifications that would, in many ways, be equivalent to a new license application. Moreover, nothing in SBA's regulations prevents a non-leveraged SBIC with an early stage focus from applying for the Early Stage SBIC program if that SBIC wishes to access Early Stage leverage. Therefore, SBA does not propose to implement this suggestion.

- *Increase the maximum leverage to \$100 million.* Although SBA received comments that indicated the maximum leverage for Early Stage SBICs should be increased to \$100 million, SBA was concerned that, based on its expected \$200 million annual allocation of Early Stage leverage, this could concentrate the limited Early Stage allocation to only two funds per year. SBA therefore chose to propose a maximum leverage ceiling of only \$75 million per year. SBA also considered only approving a higher maximum for new Early Stage SBIC applicants, but believes that existing Early Stage SBICs should be able to benefit from this increase.

3. Potential Benefits and Costs

The proposed rule reflects SBA's intent to continue licensing and providing SBA-guaranteed leverage to Early Stage SBICs, and would make material improvements to the program. Even though currently licensed Early Stage SBICs are eligible for almost \$220

million in commitments, Early Stage SBICs have requested and been approved for less than \$113 million in leverage commitments and have issued less than \$44 million in Debentures through September 2015. Most venture funds have a 5-year investment period with follow-on financings in later years, so it is not unusual that these funds have not applied for or drawn all available leverage. SBA expects Early Stage SBICs to draw additional capital and leverage over a 5 to 7 year period to support financings and operational expenses, commensurate with this investment cycle. Despite the relatively small amount of leverage drawn, Early Stage SBICs have made over \$94 million in financings to 46 small businesses through September 2015, with over half of the financing dollars reported in FY 2015. Since most Early Stage SBICs did not start reporting financings until 2014, and venture funds typically have a 5 year investment period, SBA expects funds to continue to make \$50 to \$75 million in financings per year for the next 2 to 3 years and then decline, unless new Early Stage SBICs are licensed.

As previously noted, the Early Stage program finances geographic funding gaps and creates jobs. Over 69% of Early Stage SBIC financing dollars went to states not in the traditional geographic hubs for venture capital financing. In addition, Early Stage SBIC financial reports filed with SBA for Early Stage SBICs' fiscal year 2014 showed a net gain in jobs of 48% in the small businesses Early Stage SBICs had invested in during 2014.

In terms of cost, since fiscal year 2012, the SBIC Debenture subsidy formulation model has taken into account Early Stage SBICs. Early Stage SBICs have a higher expected loss rate than standard SBICs, so the more leverage SBA allocates to Early Stage SBICs results in a proportionally higher annual charge. As noted in the April 27,

2012 final rule that established Early Stage SBICs (77 FR 25042), SBA allocated \$150 million in leverage commitments (i.e., 7% of SBA's total leverage authorization) to Early Stage SBICs for FY 2012. This allocation increased the FY 2012 annual charge for all SBICs by 13.7 basis points. For FY 2017, based on current demand, SBA has budgeted \$100 million in Early Stage commitments (i.e., 4% of SBA's total leverage authorization). SBA expects this allocation to increase the annual charge paid by all SBICs by less than 7 basis points, which is smaller than the increase to the annual charge related to the \$200 million allocation for each of FYs 2012-2016. After FY 2017, SBA expects to allocate no more than approximately \$200 million in leverage commitments to Early Stage SBICs in any year, which would keep the increase in cost related to the Early Stage program to no more than approximately 14 basis points. Depending on demand, Early Stage SBIC performance, and other factors, SBA may modify this targeted allocation. SBA believes that none of the changes proposed in this rule would alter the risk profile of the Early Stage SBICs or increase the annual charge paid by SBICs. The program will remain a zero subsidy program.

Executive Order 12988

This action meets applicable standards set forth in section 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have retroactive or presumptive effect.

Executive Order 13132

The rule will not have substantial direct effects on the States, or the distribution of power and responsibilities among the various levels of government. Therefore, for the

purposes of Executive Order 13132, Federalism, SBA determines that this proposed rule has no federalism implications warranting the preparation of a federalism assessment.

Executive Order 13563

This proposed rule was developed based on comments received on the ANPRM SBA issued in March 2015 (80 FR 14034) and several discussions with Early Stage participants and others in the industry. SBA issued the ANPRM to solicit comments and ideas on the Early Stage SBIC program and considered each comment it received. The proposed changes are a result of those comments.

Paperwork Reduction Act, 44 U.S.C. Ch. 35

SBA has determined that this rule proposes no additional reporting or recordkeeping requirements as defined by the Paperwork Reduction Act.

Regulatory Flexibility Act, 5 U.S.C. 601-612

When an agency promulgates a rule, the Regulatory Flexibility Act requires the agency to prepare an initial regulatory flexibility analysis (IRFA), which describes the potential economic impact of the rule on small entities and alternatives that may minimize that impact. Section 605 of the RFA allows an agency to certify a rule, in lieu of preparing an IRFA, if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities.

This proposed rule would affect the existing five Early Stage SBICs, as well as all potential applicants, all of which are small entities. Although SBA is seeking to expand the number of participants, because of the limited amount of available leverage, even with future growth, the number of affected small entities will still be relatively low. SBA has determined that the impact on entities affected by the rule will not be significant.

Because SBA's subsidy model already takes into account Early Stage SBICs and the proposed rule does not impact the current annual fee needed to keep the Debenture program at a zero subsidy cost, no cost impacts are expected.

List of Subjects in 13 CFR Part 107

Examination fees, Investment companies, Loan programs-business, Licensing fees, Small businesses.

For the reasons stated in the preamble, SBA proposes to amend part 107 of title 13 of the Code of Federal Regulations as follows:

PART 107 - SMALL BUSINESS INVESTMENT COMPANIES

1. The authority citation for part 107 is revised to read as follows:

Authority: 15 U.S.C. 681, 683, 687(c), 687b, 687d, 687g, and 687m.

§107.310 [Removed and Reserved]

2. Remove and reserve §107.310.

3. Revise §107.320(b) to read as follows:

§107.320 Evaluation of Early Stage SBICs.

(b) The geographic location of projected investments based on the applicant's business plan.

4. Revise §107.565 to read as follows:

§107.565 Restrictions on third-party debt of Early Stage SBICs.

(a) *General.* If you are an Early Stage SBIC and you have outstanding Leverage or a Leverage commitment, you must get SBA's prior written approval to have, incur, or

refinance any third-party debt other than accounts payable from routine business operations, unless such debt satisfies the conditions in paragraph (b) of this section.

(b) *Qualified line of credit.* Without obtaining SBA's prior written approval, an Early Stage SBICs may have, incur, or refinance third party debt that meets all of the following conditions:

(1) The third party debt is a line of credit with maximum availability limited to the lesser of:

(i) 20% of Regulatory Capital; or

(ii) Total unfunded binding commitments from Institutional Investors minus any such commitments used to fund the Interest Reserve under §107.1181.

(2) The term of the line of credit does not exceed 24 months, but may be renewable, provided that each renewal does not exceed 24 months and you are in compliance with the conditions of this paragraph (b).

(3) The line of credit is held by a federally regulated financial institution.

(4) All borrowings under the line of credit:

(i) Are not secured third-party debt, as that term is defined in §107.550(a);

(ii) Are for the purpose of maintaining your operating liquidity or providing funds for a particular Financing of a Small Business;

(iii) Must be fully repaid within 90 days after the date they are drawn; and

(iv) Must be fully paid off for at least 30 consecutive days during your fiscal year.

5. Amend §107.1150 by revising paragraphs (c)(1) and (c)(3)(ii), to read as follows:

§107.1150 Maximum amount of Leverage for a Section 301(c) Licensee.

(c) ***

(1) The total amount of any and all Leverage commitments you receive from SBA shall not exceed 100 percent of your highest Regulatory Capital or \$75 million, whichever is less;

(3)***

(ii) \$75 million.

Dated: August 26, 2016

Maria Contreras-Sweet,
Administrator

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